Session 8B: Post Class tests

1. The pre-tax cost of debt is a component in the cost of capital. Which of the following best describes what you are trying to estimate, in this calculation?
    a. The actual cost on the company's existing debt
    b. The cost of borrowing on just the company's safest debt
    c. The cost of borrowing on the company's most expensive debt
    d. The cost of borrowing money today, based upon the maturity of the actual debt of the firm
    e. The cost of borrowing money today, on long term debt
2. Which of the following statements about the pre-tax cost of debt is **not true**?
    a. The pre-tax cost of debt for a company will always be higher than the risk free rate, in any currency
    b. The pre-tax cost of debt for a company will fall, if the risk free rate falls
    c. The pre-tax cost of debt for a company will increase, if the default risk in the company increases
    d. The pre-tax cost of debt for a firm can be computed by looking at its peer group firms' cost of debt (like a bottom up beta)
    e. All of them
3. You are trying to compute the market value of debt for a company that has only bank loans. The company has $2.5 billion in face value of debt and made interest expenses of $100 million on this debt last year. If the weighted average maturity of the debt is five years, and the company's current pre-tax cost of debt is 5%, estimate the market value of debt. (You can assume annual interest payments)
    a. $1.96 billion
    b. $2.00 billion
    c. $2.39 billion
    d. $2.50 billion
    e. $3.00 billion
4. The government confers a tax benefit on companies that borrow money. To compute this tax benefit for a company with taxable income, which of the following tax rates should you be using?
    a. The cash tax rate (Cash taxes paid/ Taxable income)
    b. Effective tax rate (Accrual taxes paid/Taxable income0
    c. Marginal tax rate (Tax rate on the last dollar of income)
    d. Industry-average tax rate
    e. None of the above
5. Assume that you are computing the cost of capital for a company whose only debt is 10-year convertible debt, with a face value of $300 million and a coupon rate of 0%. The company has a BBB bond rating, which results in a default spread of 2% over the riskfree rate (which is 3%). If the market value of the convertible bond is $400 million, what is the breakdown for debt and equity in this convertible bond?
    a. $400 million in equity, no debt (because coupon is zero)

b. $216 million in equity, $184 million in debt
c. $154 million in equity, $246 million in debt
d. $177 million in equity, $223 million in debt
e. $100 million in equity, $300 million (face value) in debt
f. $0 in equity, $400 million in debt (because it has not been converted)